

March 1995

TRUST ASSETS

Investment of Trust Assets in Bank Proprietary Mutual Funds





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-259962

March 16, 1995

The Honorable Thomas J. Bliley, Jr., Chairman
The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

The Honorable James A. Leach, Chairman
The Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking and Financial
Services
House of Representatives

This report is in partial response to the Committees' requests for information about bank mutual fund activities. We reviewed the investment of trust assets¹ in bank proprietary mutual funds,² and we plan to address the Committees' requests for other information about bank mutual fund activities in future reports. For this report, we sought to determine (1) the extent to which banks have invested assets in trust accounts in bank proprietary mutual funds, including the extent to which trust assets have been converted to proprietary mutual funds;³ (2) the disclosure and consent requirements that apply when trust assets are invested in proprietary mutual funds; (3) whether the law permits double fees⁴ on trust assets invested in proprietary mutual funds; and (4) the nature of controls against banks acting in their self-interest when trust assets are invested in proprietary mutual funds.

¹The term "trust assets" refers to assets that a bank receives and, for a fee, manages as a fiduciary. Trust assets are held mainly by commercial banks and nondeposit trust companies, which are generally subsidiaries or affiliates of commercial banks. Trust assets are booked separately from a bank's general assets, such as its loans. Trust assets may not be used for the operation of the bank and are generally not federally insured.

²Proprietary mutual funds are defined in this report as those mutual funds for which a bank, its subsidiaries, or affiliates provide investment advice (i.e., advice regarding purchasing, holding, or selling securities). The bank does not, however, legally own or control proprietary mutual funds. Under the Investment Company Act of 1940, a mutual fund is controlled by independent boards of directors, a majority of which cannot be officers, directors, or employees of any one bank. The independent mutual fund board selects the investment advisor and must be able to dismiss the investment advisor at any time.

³In this report, conversion refers to the process of either liquidating or exchanging existing trust asset investments and placing the resulting cash or exchanged assets in a proprietary mutual fund.

⁴The term "double fees," as used in this report, refers to investment advisory fees. A bank that charges such fee at the trust level and another at the proprietary mutual fund level would be charging double fees.

Scope and Methodology

Neither industry data nor data collected by federal regulators document the extent to which banks have invested trust assets in proprietary mutual funds. However, we were able to gain some insight into this question by comparing several data sources. Some relevant statistical information was available from the reports on trust assets that banks must submit annually to federal regulators and from mutual fund data compiled by Lipper Analytical Services, a private firm. To understand the types of trust assets that might be converted into mutual funds, we talked to federal bank regulators at the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC). We also interviewed trust department officials at 10 banks to understand the extent to which banks have invested trust assets in mutual funds. The banks had trust departments ranging from several billion to hundreds of billions of dollars in trust assets. These banks were chosen on a judgment basis and do not represent a statistically valid sample.

To address questions about disclosure, consent, fees, and controls over banks acting in their self-interest when investing trust assets in proprietary mutual funds, we (1) reviewed relevant legislation, (2) talked to the federal bank regulators mentioned above, (3) reviewed 13 examination reports of trust departments, and (4) talked to officials at the Department of Labor and the Securities and Exchange Commission (SEC). The American Bankers Association (ABA) provided us with data from a 1993 survey on the status of state laws governing the investment of trust assets in proprietary mutual funds.⁵ We also received comments from the Federal Reserve, OCC, FDIC, and Labor, which we incorporated into the report where applicable. A more detailed discussion of the scope and methodology of our work is presented in appendix I.

Results in Brief

Some funds from bank trust departments have been invested in proprietary mutual funds. However, available evidence suggested that most of the trust assets for which banks had given investment advice had not been invested in proprietary mutual funds. In addition, the majority of funds invested in bank proprietary mutual funds appeared to be from sources other than trust assets. From the available data we found that

- at the end of 1993, bank trust departments provided investment management services⁶ to accounts with about \$2 trillion in assets.

⁵ABA collected information from 39 states that responded to their survey.

⁶These services ranged from simply giving advice to an outside party that had sole authority to make investment decisions to the bank having sole authority to direct investments.

Proprietary mutual funds, by contrast, contained about \$200 billion in assets;

- Lipper estimated that from 1985 through 1992 about \$24 billion in trust assets had been used to start up proprietary mutual funds. This represented about 15 percent of the total assets in bank proprietary mutual funds at the end of 1992. Industry experts said that this was likely to have been an underestimate of the amount of trust assets invested in proprietary mutual funds, since it did not take into account the developments that took place after the start-up period. These developments included additional conversions and investment of new trust money directly into proprietary mutual funds;
- statistics on trust assets showed that at the end of 1993 about \$45 billion in employee benefit and personal trust assets were invested in money market mutual funds (MMMFS).⁷ These assets represented about one-third of the assets in proprietary MMMFS. However, it is likely this overestimated the amount of trust assets invested in proprietary MMMFS, since the data did not differentiate between investments in proprietary and nonproprietary MMMFS.

According to the bankers we interviewed, proprietary mutual funds were becoming a more important investment choice for trusts. Industry and regulatory officials also said that for tax reasons most existing trust assets that could be converted to proprietary mutual funds likely will be from employee benefit accounts rather than personal trusts.⁸

Federal laws and some state laws have established various disclosure and consent requirements relating to the investment of trust assets in proprietary mutual funds. Before any initial investment of employee benefit plan assets in a proprietary mutual fund, Labor requires, under the Employee Retirement Income Security Act of 1974 (ERISA) and related rules, that both disclosure be made to and consent obtained from a second fiduciary that is independent of the bank. Disclosure requirements pertaining to the investment of personal trust assets vary by state. Most states allowing investment of personal trust assets in proprietary mutual funds do not require beneficiary consent.

Under ERISA, Labor prohibits charging double fees to employee benefit accounts. According to the ABA survey, 8 states prohibit charging double

⁷These are a type of mutual fund that invest in short-term securities.

⁸Conversion of personal trust assets to a mutual fund was viewed by many bankers as likely being considered a taxable event by the Internal Revenue Service. This issue does not arise with employee benefit accounts because these accounts receive deferred tax status.

fees to personal trusts, 27 allow charging double fees, and 4 states are silent about which fees may be charged. Information about the laws of other states was not readily available. According to bankers we interviewed, even without a state prohibition, banks will not necessarily charge double fees because of factors such as possible action by federal regulators, competition, and threats of beneficiary lawsuits. For a variety of reasons, we could not determine whether banks in states allowing double fees were more likely to invest trust assets in proprietary mutual funds than banks in other states.

As fiduciaries, banks are prohibited by law and regulation from acting in their self-interest when it conflicts with the interest of a trust. Moreover, banks must be able to justify trust investments in terms of performance and suitability for the trust accounts. These general requirements as well as other, more specific related requirements are contained in trust examination manuals and are to be applied by federal bank regulators when reviewing trust investments in proprietary mutual funds. Because we have only looked at a limited number of examinations, and the use of proprietary mutual funds in trusts is relatively new, we have no basis for judging the effectiveness of trust examinations in detecting and controlling any abuses related to trust account investments in proprietary mutual funds.

Background

About 3,000 banks reported in 1992 that they provided fiduciary services to individuals, corporations, and charities (See app. II.) At year-end 1993, these services involved over 11 million accounts with total assets of about \$10.6 trillion. Most trust assets were in custodial or other accounts for which the bank did not provide investment management service. About \$2 trillion of the \$10.6 trillion were in discretionary trust asset accounts (i.e., accounts for which banks provided investment management service). Most assets in these discretionary accounts were managed for employee benefit plans (\$914 billion) and personal trusts (\$556 billion).⁹

In 1993, \$760 billion—representing approximately half of the funds contained in discretionary employee benefit plans and personal trusts—were invested in pooled trust investment funds.¹⁰ Discretionary

⁹The remaining \$577 billion was accounted for in "other accounts," as explained in appendix II.

¹⁰All assets in pooled trust investment funds are classified as discretionary trust assets regardless of whether the bank provided any investment management service concerning the initial placement of funds in the pooled trust investment fund. According to regulators, this classification is made because the bank has discretion concerning how the pooled funds are invested.

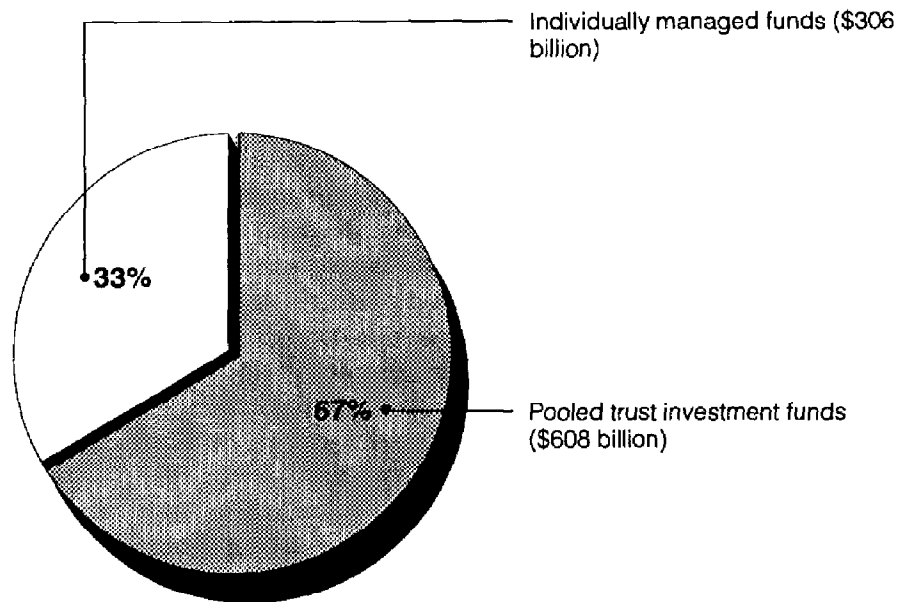
trust assets that were not invested in pooled funds were invested in separate portfolios for each account. Pooled trust investment funds were generally used for relatively small accounts or to achieve diversification in areas that were too costly to achieve on an individual account basis.

Pooled trust investment funds are similar to mutual funds in that the cash assets of many trust accounts are commingled in a single investment portfolio for the proportional benefit of all participating accounts. Pooled trust investment funds, like mutual funds, may serve different investment objectives and can be invested in such instruments as short-term treasuries, long-term bonds, growth stocks, and tax-free bonds. However, unlike mutual funds, pooled trust investment funds are not marketed to the general public. Pooled trust investment funds can be transferred to a bank proprietary mutual fund in a single transaction known as a conversion.

Pooled trust investment funds for employee benefit accounts and personal trusts differ in some ways. The pooled funds are maintained separately for each type of account because employee benefit plans have different legal requirements.¹¹ Pooled trust investment funds for personal trusts are called common trust funds. At the end of 1993, two-thirds of the discretionary employee benefit fund trust assets were placed in pooled trust investment funds, while less than one-third of the discretionary assets of personal trusts were placed in common trust funds. (See figs. 1 and 2.)

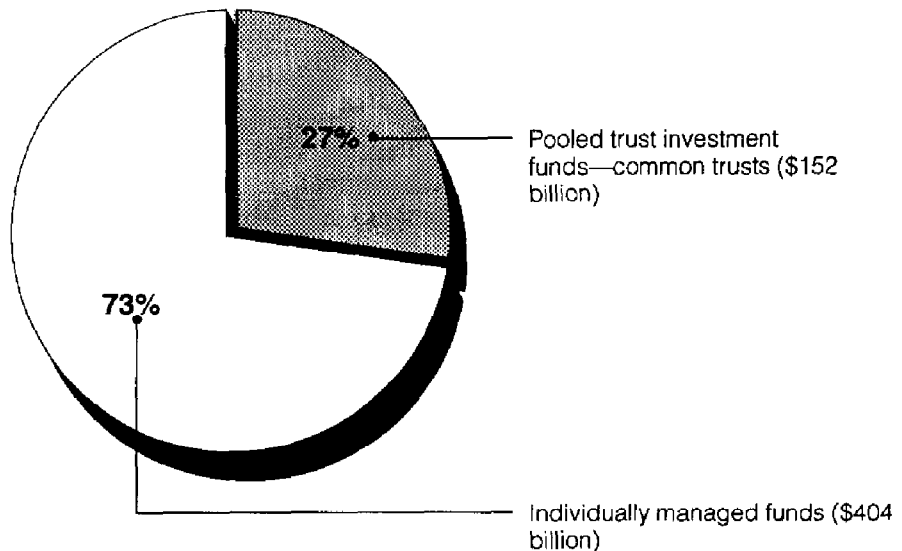
¹¹For example, tax liabilities created from the investment of trust assets are deferred for employee benefit plans, while they are passed through to income beneficiaries in personal trusts.

Figure 1: Distribution of Employee Benefit Plan Assets as of December 1993 (Dollars in Billions)



Source: GAO calculations based on FDIC data.

Figure 2: Distribution of Personal Trust Assets as of December 1993 (Dollars in Billions)



Source: GAO calculations based on FDIC data.

Unlike mutual funds, a bank's operation of a pooled trust investment fund is specifically not covered by the Investment Company Act of 1940 or the Securities Act of 1933. Instead, banks acting as trustees are subject to a substantial body of federal, state, and common laws and regulations in addition to those governing the usual commercial banking activities.

Employee benefit plans are governed by ERISA's fiduciary responsibility provisions, which are administered by Labor.¹² ERISA allows the investment of trust assets in proprietary mutual funds for employee benefit plans. State law as well as the trust agreement governs allowable investments for personal trusts. At least 39 states and the District of Columbia allow personal trust assets to be invested in proprietary mutual funds. We could not determine the status of the remaining 11 states from available information.

¹²ERISA governs all fiduciaries managing employee benefit plan assets. The act prohibits a trustee (the bank) from engaging in self-dealing, which covers virtually any transaction between a plan and any party related to the plan trustee. However, the act authorizes Labor, in coordination with the Department of the Treasury, to grant exemptive relief for otherwise prohibited transactions on an individual or class basis upon making certain findings on the public record.

Two common-law principles underlie the operation and regulation of trusts: the duty of loyalty and prudence. The duty of loyalty requires a fiduciary to act solely in the interests of its clients, excluding all self-interest. Banks are required to resolve any possible conflicts of interest in favor of the trust account and its beneficiaries, not the bank. In addition, the fiduciary is to avoid situations of potential conflict of interest that may prevent it from serving in the best interest of a client. Prudence requires banks that act as fiduciaries to be able to justify the suitability of trust investments for trust accounts.

Federal trust regulatory authority stems in part from the fact that the bank regulators have the authority to grant or terminate the trust powers of banks and bank holding companies and their bank and trust subsidiaries. Under 12 U.S.C. 92a, OCC is authorized to grant permission for a national bank to act as a fiduciary and to promulgate regulations governing the proper exercise of fiduciary powers. OCC supervises the trust activities of national banks under regulation 12 C.F.R. part 9. State banks' trust activities are supervised by the Federal Reserve or FDIC using regulations similar to OCC's. The Federal Reserve also supervises the trust company subsidiaries of bank holding companies. Federal regulation of common trust funds has been strengthened by an Internal Revenue Code requirement that state banks must adhere to section 9.18 of OCC's regulations to qualify for certain federal tax benefits.

Laws Vary on the Investment of Trust Assets in Proprietary Mutual Funds

Federal bank regulators allow banks to invest trust assets in securities, including those of a proprietary mutual fund, only if the purchase is permitted by ERISA for employee benefit accounts, or by state law, the trust instrument, or court order for personal trust accounts. Without specific federal or state legislation authorizing the use of proprietary mutual funds in trust accounts, OCC officials said that such use is a breach of trust because of the unauthorized conflict of interest.

Labor permits the investment of trust assets in proprietary mutual funds under a set of conditions stated in Prohibited Transactions Exemption

(PTE) 77-4.¹³ According to the ABA survey, at least 39 states allow bank fiduciaries to invest trust assets in proprietary mutual funds. Regardless of state law, under its Regulation Y, the Federal Reserve prohibits bank fiduciaries from purchasing, in their sole discretion, proprietary mutual funds if the advisor to the fund is a subsidiary of the bank holding company. The Federal Reserve stated that banks that had been criticized under this provision have responded by either restructuring the investment advisor as a subsidiary of the bank, rather than of the bank holding company, or obtained co-trustees who have given consent or used outside counsel to petition the Federal Reserve to reexamine its interpretation of Regulation Y provisions.

Evidence on the Investment of Trust Assets in Proprietary Mutual Funds

While it was not possible to quantify the exact extent to which assets in trust accounts had been invested in bank proprietary mutual funds, some inferences could be drawn from the information that was available. For example, while trust assets had been invested in proprietary mutual funds, most of the assets in proprietary mutual funds appeared to have come from other sources. Two, the level of funds contained in discretionary trust accounts far exceeded the amount of assets in proprietary mutual funds. Finally, industry and regulatory officials said that most of the trust assets that had been converted into proprietary mutual funds had come from employee benefit accounts.

The Volume of Trust Assets Greatly Exceeds That of Proprietary Mutual Funds

Bank proprietary mutual funds held about \$202 billion in assets at the end of 1993, an increase of \$187 billion since 1983. Data were not available to indicate what portion of that total came from each bank's trust assets. However, even if all the assets in bank proprietary mutual funds came from the investment of trust assets, they would represent only 15 percent of the \$1.5 trillion in discretionary employee benefit and personal trust assets.

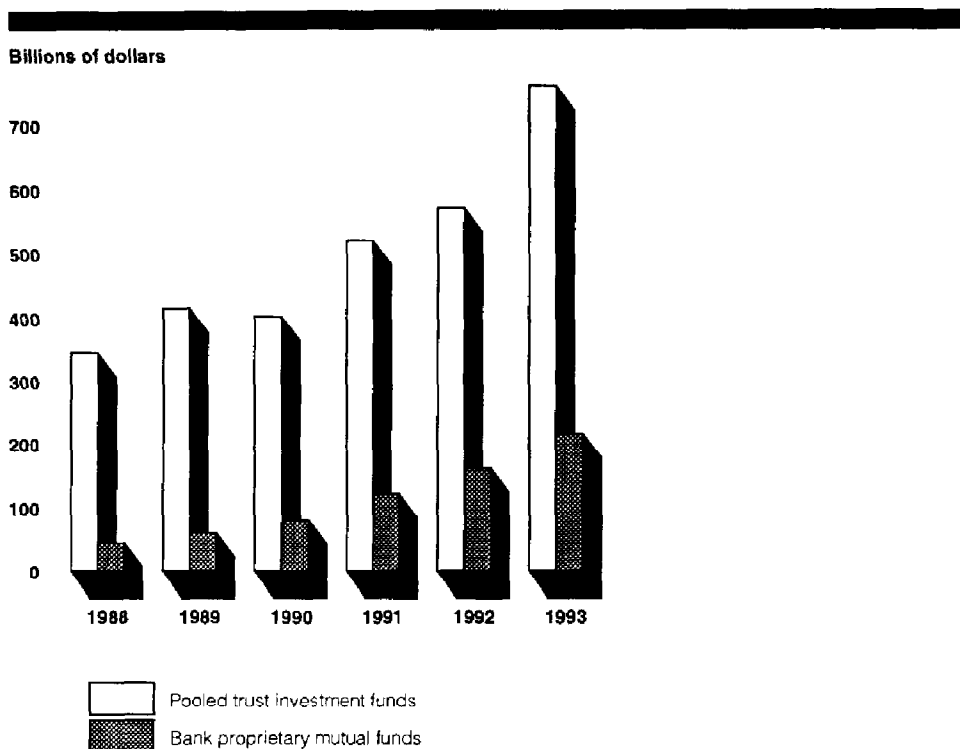
¹³Labor is authorized to grant exemptive relief for otherwise prohibited transactions on an individual or class basis. PTE 77-4 is a class exemption that permits the investment of employee benefit assets in proprietary mutual funds. Labor stated that this exemption technically only applies to those conversions where trust assets are first converted to cash and then invested in proprietary mutual funds. Labor acknowledged conversions have been done using this exemption where the trust assets were not first converted to cash but were transferred directly to the proprietary mutual fund. Labor stated that this would only be a technical violation of the exemption in the absence of other factors indicating self-dealing and that it was not aware of any problems among the banks that had met the conditions in PTE 77-4.

Limited Data on Trust Assets Converted to Proprietary Mutual Funds

Because bank proprietary mutual funds provide a close alternative investment vehicle to a trust department's pooled trust investment funds, we examined pooled trust investment funds to determine whether the volume of assets or the number of pooled trust investment funds had declined since the introduction of proprietary mutual funds. Such developments could be expected if pooled trust funds were being converted to proprietary mutual funds in substantial amounts.

As figure 3 shows, pooled trust investment funds were still a more widely used investment vehicle for trusts as compared with proprietary mutual funds. From 1983 to 1993, the total of pooled trust investment funds, net of any decreases caused by conversions to proprietary mutual funds, grew from \$150 billion to \$760 billion. Moreover, at the end of 1993, 95 percent of the assets in pooled trust investment funds were in banks that also offered proprietary mutual funds. Most banks that offered pooled trust investment funds in 1986 continued to do so in 1993. While some banks discontinued pooled funds between 1986 and 1993, other banks increased the number of pooled trust investment funds they offered, and some banks offered pooled funds for the first time. Appendix IV discusses the status and trends in banks that offered both pooled trust investment funds and proprietary mutual funds.

Figure 3: Comparison of Bank Proprietary Mutual Funds to Pooled Trust Investment Funds, 1988-1993



Source: GAO calculations based on FDIC data.

According to the annual data collected by federal bank regulators, the concentration of pooled trust investment funds in the largest banks has increased over the last several years. In 1993, the 10 largest banks held 75 percent of all pooled trust investment fund assets, compared with 55 percent of such assets in 1986. We do not know the reason for this change, although large bank and large corporate mergers could be contributing factors. We also do not know what effect this increased concentration has had or will have on the prospects for conversions to mutual funds.

Trust Assets Have Been Invested in Proprietary Mutual Funds

Evidence from press accounts and our discussions with bankers and bank regulators indicated that trust assets had been used to establish proprietary mutual funds. Lipper collected data from SEC registration filings of newly organized bank proprietary mutual funds to estimate the

volume of trust assets used to start up proprietary mutual funds. Lipper reviewed these data and calculated that from 1985 through 1992, about \$24 billion of trust assets were converted to proprietary mutual funds. (See table 1.) Lipper calculated this amount by assuming that newly registered bank proprietary mutual funds that reported a significant amount of assets at inception acquired those assets through the conversion of trust assets. The \$24 billion represented about 15 percent of the \$161 billion in total assets invested in proprietary mutual funds at the end of 1992.

Table 1: Estimated Use of Trust Assets to Start Up Bank Proprietary Mutual Funds, 1985-1992

Dollars in millions

Year	Money market mutual funds	Long-term debt and equity mutual funds	Total conversions	Long-term debt and equity conversions as a percent of total conversions
1985	\$178	\$0	\$178	0%
1986	915	20	935	2
1987	2,128	55	2,183	3
1988	2,552	1,340	3,892	34
1989	2,056	1,024	3,080	33
1990	773	640	1,413	45
1991	802	2,123	2,925	73
1992	2,696	6,624	9,320	71
Total	\$12,100	\$11,826	\$23,926	49%

Source: Lipper Analytical Services, "Conversion of Trust Assets into Bank-Related Mutual Funds," 1993.

For 1985 to 1990, Lipper estimated that most of the trust asset conversions were into MMMFs. However, in 1991 and 1992 most were conversions into long-term debt and equity mutual funds. Lipper reported that MMMFs accounted for the majority of assets in bank proprietary mutual funds.¹⁴ Thus, conversions of trust assets represented a larger portion of the assets in proprietary long-term debt and equity mutual funds than in MMMFs.

These data indicated only the volume of trust assets (which could be from pooled or nonpooled sources) assumed to have been placed in proprietary

¹⁴Lipper reported that at the end of 1993 about \$133 billion of the \$215 billion in proprietary mutual funds were invested in proprietary MMMFs.

mutual funds at the start-up of a fund.¹⁵ Industry experts said that these numbers likely understated the amount of trust assets invested in proprietary mutual funds because they did not include the amount of trust assets that had been invested in or converted to mutual funds after the fund's start-up.

At the end of 1993, banks reported that \$23 billion in discretionary employee benefit assets and \$22 billion in discretionary personal trusts assets were invested in MMMFs. We do not know what portion of these investments were in proprietary MMMFs, but if all of the assets were invested in proprietary mutual funds they would have accounted for only one-third of the assets in proprietary MMMFs. Data on the amount of trust assets invested in long-term debt and equity mutual funds were not separately reported.

Employee Benefit Funds Likely Account for Most Conversions

Bank regulators stated that pooled trust investment funds are a likely source of trust funds for conversion into proprietary mutual funds. We do not know how much of proprietary mutual funds has come from pooled trust investment funds. Because capital gains taxes are deferred on funds invested in employee benefit plans, most trust assets that have been converted into mutual funds—including those in the banks we interviewed—have likely come from pooled employee benefit funds. A few banks have converted common trust funds into proprietary mutual funds, but none of the bankers we spoke with had done so. However, these bankers said they believed many more conversions of common trust funds would occur if tax laws were changed to clearly allow a tax-deferred transfer of common trust fund assets to mutual funds. Congress passed clarifying legislation that would have allowed tax-deferred conversions as part of other legislation in 1992, but the President vetoed the bill.¹⁶

Increased Use of Mutual Funds Is Expected

Bankers told us that many trust customers prefer to have their accounts invested in a mutual fund rather than a pooled trust investment fund. These bankers said that mutual funds, unlike pooled funds, have become widely accepted by the general public as an investment vehicle. Also, they

¹⁵Trust assets may be invested in proprietary mutual funds in two ways. First, the assets in individually managed (nonpooled) trust accounts can be wholly or partly invested in shares of the mutual fund on an account-by-account basis. Second, the assets of a pooled trust investment fund can be transferred to a mutual fund in a single transaction known as a conversion. This can be accomplished either by liquidating the assets in the pooled trust investment fund and simultaneously investing the cash proceeds in the mutual fund or by exchanging the pooled trust investment fund's assets for shares in the mutual fund.

¹⁶The House passed legislation again in 1994, but the Senate did not consider the issue.

said that the services routinely offered by mutual funds are in some respect superior to pooled trust investment funds.¹⁷ For example,

- mutual funds are priced at market daily, rather than monthly or quarterly, and the funds' performance can be followed in the daily press;
- money can be invested or withdrawn daily, rather than monthly or quarterly; and
- distributions can, if desired by the customer, be paid out in shares of the mutual fund, rather than only in cash.

These bankers said that mutual funds may also provide a wider range of investment choices than pooled trust investment funds. For example, a proprietary mutual fund might attract enough trust and nontrust investors to justify specialized funds in such areas as small companies or foreign investments. However, the trust customers alone may not provide a large enough base to support the overhead and transactions costs of running these funds.

Disclosure and Consent Requirements

Federal laws and some state laws have established various requirements relating to the disclosure of and consent for investment of trust assets in proprietary mutual funds.

Disclosure and Consent Requirements for Employee Benefit Plans

Under conditions set out in PTE 77-4, Labor requires disclosure of the investment of employee benefit assets in proprietary mutual funds to a second, independent fiduciary as well as the consent to such an investment by the independent fiduciary. PTE 77-4 does not require that Labor or the bank regulators be notified or provide advance approval. Instead, PTE 77-4 establishes bank procedures regarding (1) what must be disclosed and to whom, (2) fees, and (3) conflicts of interest. Provision of the mutual fund prospectus, disclosure of fees paid by the employee benefit plan, and an explanation of why the investment is appropriate must be made to a second fiduciary, who is to be chosen by the plan and independent of the bank. The second fiduciary must give consent before the conversion. Labor specifies that consent may be limited to fees to be charged.

Of those banks we visited that had converted employee benefit plan assets into proprietary mutual funds, all had relied on PTE 77-4. These banks sent

¹⁷FDIC stated in its comments to this report that a number of these benefits could also be provided by pooled trust investment funds.

disclosure letters and consent forms to the independent fiduciaries of the plans. A sample of the letters revealed that these banks discussed the benefits of investing in the proprietary mutual funds and disclosed their relationship to the funds and the fees that would be charged.¹⁸ Several letters also discussed how funds in the accounts would be handled if the fiduciaries did not agree to the conversion. In only one case did a bank fail to obtain positive consent before the conversion took place.¹⁹ In an examination report, federal regulators cited the bank for failure to obtain positive consent in a timely manner.

Disclosure and Consent Requirements for Personal Trust Accounts

For investing the assets of personal trust accounts in a proprietary mutual fund, the issue of disclosure concerns whether beneficiaries are notified about the fees charged for such investments.²⁰ According to the ABA survey, disclosure requirements vary, with about half of the 39 respondent states saying they required fee disclosure to trust customers.

In implementing the conversion of a common trust fund into a proprietary mutual fund, some of the bankers we interviewed said they would send disclosure notices to current income beneficiaries even if the law or trust agreement did not require it. We do not know whether these policies are representative of the industry.

For personal trusts, the ABA survey reported that beneficiary consent is not required in almost all of the 39 states that responded. Federal bank regulators said that requiring consent could be a problem in some personal trusts where some future beneficiaries may not even be born. New trust agreements are often written to allow investment of trust assets in proprietary mutual funds.

Fees

Trust departments normally charge a fee for managing investments in a trust account, including a fee for providing investment advice. Similarly, the investment advisor to a mutual fund, including bank proprietary funds,

¹⁸The amount of detail regarding account fees varied among banks. Some letters simply indicated which fees were received by the bank as a result of its relationship with the fund and how these fees would be handled in the trust account. Other letters discussed the mutual fund's expenses as well. Fund prospectuses or requests for prospectuses were sent with the letters. Some letters also stated that their mutual funds were not covered by federal deposit insurance.

¹⁹Positive consent refers to receiving approval for the conversion from the independent fiduciary rather than assuming approval if a negative response was not received.

²⁰Two states also require that the nature of the relationship between the trustee and the proprietary mutual fund be disclosed. Disclosure that these investments do not receive federal deposit insurance is not generally thought of as necessary for traditional trust customers because they are assumed to be sophisticated investors.

normally charges a fee for investment advice, which is paid out of the assets of the fund. Thus, by investing trust assets in proprietary mutual funds, a bank creates a possibility of collecting two fees for investment advice (i.e., collecting both trust fees and mutual fund fees on the same trust assets). This practice is generally referred to as charging double fees.²¹

Besides paying the fee for investment advice, mutual funds may also pay fees for distribution, custody, and other services. For a trust customer, total fees could be greater for trust assets invested in proprietary mutual funds than if the trust assets were otherwise invested. However, banks' practices in charging fees when investing trust assets in proprietary mutual funds are governed by federal and some state laws, and other factors also influence those practices.

Federal and State Laws Addressing Double Fees for Investment Advice Differ

The laws governing fees charged for investment advice differ for employee benefit plans and personal trust accounts. For employee benefit plans, PTE 77-4 prohibits paying double fees for investment advice.²² For personal trust accounts, the states that allow investment of trust assets in proprietary mutual funds differ regarding permissible fees. Of the states that responded to the ABA survey, 8 prohibited charging both a trust and a mutual fund investment advisory fee, 27 permitted both fees to be charged, and 4 were silent about whether both fees may be charged.²³ We did not have data on the remaining 11 states.

Data were not available to determine whether banks were more likely to invest trust assets in proprietary mutual funds when double fees were permitted by state law. Moreover, even if data had been available, we do not know if we could have isolated other factors—such as the performance of the fund and its suitability for the investment goals of the beneficiaries of the trust accounts—that influenced the decision of whether to invest trust assets in proprietary mutual funds.

²¹SEC stated that charging double fees is not uncommon in the securities industry. SEC's principal concern is whether this arrangement is disclosed to the customer.

²²PTE 77-4 also prohibits certain types of mutual fund distribution fees, but does not address other types of fees, such as custody fees.

²³Most state laws do not address other types of fees mutual funds may charge.

A Variety of Factors Influence Bank Practices in Charging Fees

Factors other than federal and state laws also influence banks' fees when investing trust assets in proprietary mutual funds. According to bankers we interviewed, competitive forces often keep bank fees lower than the amount that could be charged under law for trust assets invested in proprietary mutual funds. They said this is especially true with employee benefit accounts and revocable personal trusts, since customers may move accounts elsewhere if fees are not competitive.

Regulatory examinations of bank trust departments may also influence banks' practices in charging fees because investments in proprietary mutual funds and the fees associated with them are susceptible to regulatory criticism and action based on common law. Bank regulatory officials told us that fees collected by banks for investing trust assets in proprietary mutual funds are a matter of concern. OCC stated that even if the investment of trust assets in a proprietary mutual fund is authorized by state law, the terms of the trust instrument, or the consent of all beneficiaries, regulators still require banks to meet common law standards of prudence and loyalty and the regulation 12 C.F.R. part 9 requirement that fees be reasonable. Thus, investments in proprietary mutual funds and the fees associated with them become susceptible to regulatory criticism and action. Beneficiary lawsuits regarding poor investment performance or fee abuse are another factor that may influence banks' practices regarding fee charges.

Bankers we interviewed said that their banks do not charge, nor would they charge, two investment advisory fees on trust assets invested in proprietary mutual funds. We were not able to determine whether or to what extent total fees would be higher on such investments than if they were otherwise invested.

Interviews Indicated Varied Fee Practices

Most of the bankers we interviewed said they preferred that their proprietary mutual funds charge the same fees to trust and other investors. These banks arranged for their trust departments to refund mutual fund advisory and sometimes other mutual fund fees to trust accounts. One bank, however, created a separate class of mutual fund shares so that it could waive its mutual fund fees directly.

Among the banks we visited that adjusted fees through their trust departments, some bankers said they itemized their trust fees into various categories of service while others charged a single comprehensive trust fee, usually based on average asset values in the account. For those banks

that have broken down their trust fees, most of the bankers said they waived either the trust or the mutual fund investment advisory fee but continued to charge a trust fee for nonadvisory services.

Of the banks we visited that charged a single trust fee, one banker said the bank planned to waive its entire trust fee on those assets invested in mutual funds. Other bankers said that their banks rebated portions of the mutual fund fees, which might have included other fees besides the investment advisory fee that their bank or affiliates received from the mutual fund.

Regulatory Controls Against Conflicts of Interest in Proprietary Mutual Funds

As we pointed out earlier in this report, regulations and laws governing trusts generally prohibit banks acting as fiduciaries from serving in their own interest when that interest conflicts with the interest of a trust. A conflict of interest arises for a banking organization when it invests trust assets in its proprietary mutual fund. As we have noted, the bank regulators address this conflict through regulation. For example, section 9.12 of OCC's regulation 12 C.F.R. part 9 establishes local law as the applicable standard of permissibility for investments involving a conflict of interest. In addition, their examination of a bank's trust activities is intended, among other things, to identify and resolve this type of conflict on a case-by-case basis. A description of federal oversight authority and trust examination programs is provided in appendix V.

Oversight of Investments in Proprietary Mutual Funds Cannot Be Evaluated Now

The federal bank regulators maintain examination manuals to test for compliance with trust laws and regulations. These manuals provide guidance to test for conflicts of interest, including conflicts involving the investment of trust assets in proprietary mutual funds. However, our review of these manuals indicated that the criteria for evaluating investments in proprietary mutual funds are rather general in nature. For example, the Federal Reserve manual, in its section on conflicts of interest, does not specifically address this issue. Also, OCC has drafted, but not yet adopted, a special set of examination procedures to cover trust investments in proprietary mutual funds.

We reviewed trust examination reports on selected banks, some of which had converted trust assets into proprietary mutual funds. The reports contained limited information regarding recent conversions. Given the limited number of examinations we reviewed and the general nature of the trust examination manuals, we have no basis for judging the effectiveness

of trust examinations in detecting and controlling unresolved conflicts of interest when investing trust assets in proprietary mutual funds.

In addition, most proprietary mutual funds are new, particularly the long-term debt and equity funds. Because it takes several years for a fund to develop a meaningful performance record, it is probably too soon to evaluate the choice of these funds as an investment vehicle for trust assets. In our limited review, we noted that

- Regulators have recognized that the investment of trust assets in proprietary mutual funds poses important regulatory issues for trusts. Examiners are to direct attention to such issues as double fees in trust examinations. These issues could become more significant if such investments continue.
- Little documentation of the review of trust asset conversions existed in the trust examination reports we reviewed. To gain some appreciation of how the general guidelines are applied in examinations, we reviewed examination reports for 13 trust departments. About half of these departments had converted trust assets to proprietary mutual funds. In one case, OCC found that the bank had failed to get appropriate authorizations from independent fiduciaries for the conversions. OCC indicated that corrective action had been taken. In another case, FDIC questioned the fees that trust customers were being charged on investments in proprietary mutual funds. FDIC indicated that a conflict of interest existed, which management should address in writing. For each of the banks that had trust conversions, there was little documentation of detailed examiner review of the transactions.
- A federal regulator may not be aware of a conversion until long after the conversion has occurred. Banks are not required to provide regulators with advance notification of trust conversions to proprietary mutual funds. Because trust examinations can be 2 or more years apart, a federal regulator may not be aware of a conversion until long after the fact. The conversion of pooled trust assets typically has been reviewed after the fact as part of the regulator's periodic trust examination.
- In the period 1991 to 1993, one violation relating to a conversion of employee benefit funds was referred to Labor. Regulators are to refer matters of noncompliance relating to employee benefit accounts to Labor. For the years 1991 to 1993, bank regulators stated that they had noted few problems with the investment of trust assets in proprietary mutual funds. Only one violation relating to a conversion of employee benefit funds had been referred to Labor, where action is pending.

Agency Comments

We requested comments on a draft of this report from the Federal Reserve, OCC, FDIC, and Labor. OCC, FDIC, and Labor provided written comments, which appear in appendixes VI through VIII, respectively. The Federal Reserve declined to provide written comments. Each of the agencies also provided us with technical comments, which have been incorporated where appropriate.

OCC and FDIC indicated that they generally concur with the report's observations. FDIC noted, however, that the benefits of investing in a mutual fund as opposed to a pooled trust investment fund (as appears on pp. 13-14) should be clarified. It noted that these benefits could be provided by pooled trust investment funds as well as mutual funds. Labor had no specific comments but provided us with an update, which we incorporated, on the referral mentioned on p. 19 of the report. Labor also said that a referral that was being considered by the Federal Reserve has since been determined not to be a violation.

We are sending copies of this report to the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the FDIC, the Secretary of Labor, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of Thomas J. McCool, Associate Director, and Stephen C. Swaim, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix IX. If you have any questions, please call me on (202) 512-8678.



James L. Bothwell
Director, Financial Institutions
and Markets Issues

Contents

Letter	1
Appendix I Scope and Methodology	26
Appendix II Trust Asset Investments and Proprietary Mutual Funds	29
Appendix III Pooled Trust Investment Funds and Proprietary Mutual Funds	32
Appendix IV Analysis of Trust Assets in Banks That Offered Pooled Trust Investment Funds and Proprietary Mutual Funds	34
Appendix V Regulatory Examinations of Trust Departments	36

Appendix VI Comments From the Office of the Comptroller of the Currency	38
Appendix VII Comments From the Federal Deposit Insurance Corporation	39
Appendix VIII Comments From the Department of Labor	40
Appendix IX Major Contributors to This Report	42
Glossary	43
Tables	
Table 1: Estimated Use of Trust Assets to Start Up Bank Proprietary Mutual Funds, 1985-1992	12
Table III.1: Comparison of Pooled Trust Investment Funds and Bank Proprietary Mutual Funds	33
Table IV.1: Profile of Banks Offering Both Pooled Trust Investment Funds and Proprietary Mutual Funds	34
Table V.1: Frequency of Examination of Trust Departments, by Federal Bank Regulator	37
Figures	
Figure 1: Distribution of Employee Benefit Plan Assets as of December 1993	6
Figure 2: Distribution of Personal Trust Assets as of December 1993	7

Contents

Figure 3: Comparison of Bank Proprietary Mutual Funds to Pooled Trust Investment Funds, 1988-1993	11
Figure II.1: Distribution of Trust Assets as of December 1993	30

Abbreviations

ABA	American Bankers Association
ERISA	Employee Retirement Income Security Act
FDIC	Federal Deposit Insurance Corporation
MMMF	Money Market Mutual Fund
OCC	Office of the Comptroller of the Currency
PTE	Prohibited Transactions Exemption
SEC	Securities and Exchange Commission

Scope and Methodology

To determine the extent to which trust assets had been invested in proprietary mutual funds, we reviewed editions of Trust Assets of Financial Institutions. This report is issued annually by the Federal Financial Institutions Examination Council, and it contains the most detailed data available regarding the investment of trust assets by banking institutions. We also reviewed statistical data on bank proprietary mutual funds provided to us by Lipper Analytical Services. Although the data on trust assets and the mutual funds data did not document the extent to which banks have invested trust assets in proprietary mutual funds, we were able to gain some insight into this question by comparing these data sources. However, there are some problems with these data, which we have noted below.

Because of the format used to collect data in Trust Assets of Financial Institutions, we could not precisely determine the extent to which trust assets were invested in mutual funds, either proprietary or nonproprietary. In addition, we encountered other problems with the data. For example, trust assets may have been double counted whenever the trust department managed a proprietary mutual fund. Also, regulators and bankers told us that the instructions for completing the report, which are complex, may result in inconsistent reporting by the banks. Finally, the 1993 data provided to us were preliminary.

The Lipper data provided information regarding the growth of proprietary mutual funds, but the source of these assets (i.e., whether from pooled trust investment funds, other trusts, or nontrust sources) was not tracked. However, Lipper provided an estimate of the amount of all types of trust assets that were invested at the start-up of a proprietary mutual fund, which Lipper identified from Securities and Exchange Commission (SEC) registration filings.

We determined that, for purposes of this report, only those trust assets for which banks provided some degree of investment advice were relevant. Furthermore, from our discussions with bankers and federal bank regulators, we determined that the most likely source of trust assets for conversion into proprietary mutual funds were those that were invested in pooled trust investment funds (since these funds are very similar to mutual funds and would provide a relatively large asset base). Therefore, we narrowed our focus further to those assets in pooled trust investment funds.

To determine disclosure and consent requirements and whether double fees are permitted, we reviewed the federal laws and regulations that are generally relevant to the investment of trust assets and in particular to the investment of such assets in proprietary mutual funds.

We interviewed officials of the federal bank regulators—the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC)—who oversee bank trust departments. We also interviewed officials at the Department of Labor who regulate the operation of employee benefit plans in accordance with the Employee Retirement Income Security Act of 1974 (ERISA) and related Labor regulations. Such plans are significant sources of trust assets. Labor oversight includes the investment of employee benefit plan assets in mutual funds. We interviewed Securities and Exchange Commission (SEC) officials to determine the nature of their oversight of mutual funds in connection with trust assets.

OCC, Federal Reserve, and FDIC officials provided the manuals used in trust department examinations and described how their examination programs test for compliance with the applicable laws and regulations. They also provided their views regarding potential fiduciary conflicts of interest, fees, disclosure, and customer consent when trust assets are invested in proprietary mutual funds. We reviewed the trust examination reports for 13 banks that were identified as operating proprietary mutual funds; about half of them had converted trust assets into proprietary mutual funds.

We obtained additional information from other sources. The American Bankers Association (ABA) provided us a survey regarding the status, as of November 1993, of the laws they identified as pertaining to the investment of trust assets in proprietary mutual funds in 39 states.

We interviewed officials of 10 banks where trust departments managed pooled trust investment funds and had either converted such investments into proprietary mutual funds or had contemplated doing so. We selected these banks on a judgment basis to reflect a variety of trust activity and because each was familiar with the issues involved in the conversion of trust assets into proprietary mutual funds. The trust assets in these banks ranged from several billion to hundreds of billions of dollars. In 1993, 3 of these banks were among the 20 largest managers of pooled trust investment funds. One bank had proprietary mutual funds that were among the 10 largest such proprietary funds offered by banks.

We were interested in each bank's policies and experience, and also in their officers' views about the prospects for the investment of trust assets in proprietary mutual funds. Specifically, we asked them why mutual funds were becoming a more commonly used investment choice and how they had dealt with issues of disclosure, consent, and fees charged in connection with trust asset investment in proprietary mutual funds. Data that would fully describe these activities were not available, and we did not independently verify the information we obtained. Because we interviewed only a limited number of banks, we do not know if the practices described in this report reflect those of the industry as a whole, and our results are not statistically valid.

Our work was done in Washington, D.C., between December 1993 and April 1994 in accordance with generally accepted government auditing standards. We obtained written comments on a draft of this report from OCC, FDIC, and Labor. These comments are discussed on p. 20 and reproduced in appendixes VI through VIII.

Trust Asset Investments and Proprietary Mutual Funds

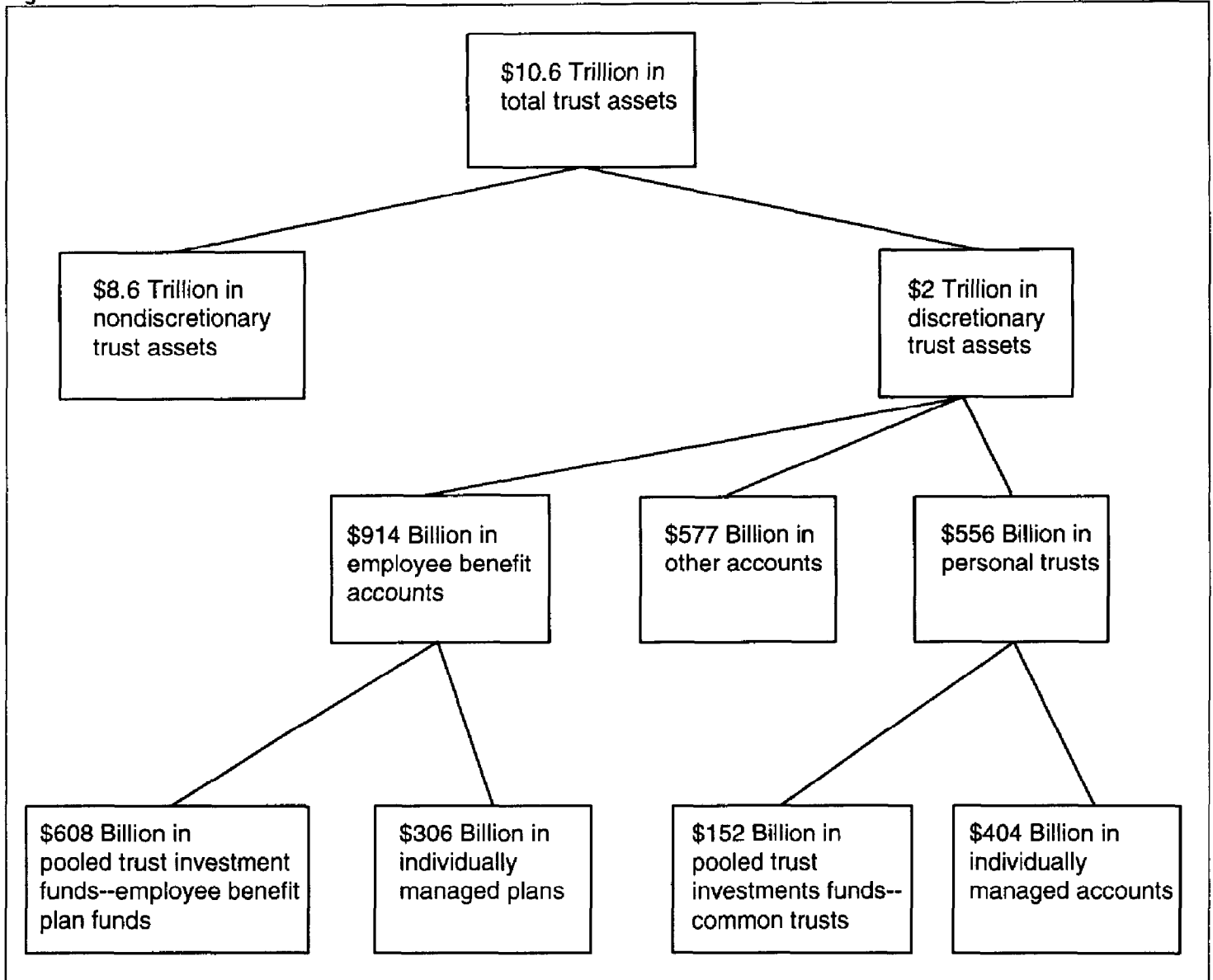
At the end of 1993, available data show that banks held \$10.6 trillion of assets in trust. Of this total, \$2 trillion were classified as discretionary trust assets. For these assets, banks are to provide investment management services. Such services can range from the bank simply giving advice to an outside party that has sole authority to make investment decisions to the bank itself having sole authority to direct investments. The remaining assets, \$8.6 trillion, were classified as nondiscretionary. For these assets, banks simply provide a variety of investment support services, such as custody of securities, dividend collections and distributions, and record keeping.

The focus of this report is on the discretionary trust assets because banks are to provide investment management services for them. Discretionary trust assets may be divided into three categories: (1) employee benefit accounts, (2) personal trust accounts, and (3) other accounts.¹ In 1993, almost half of the discretionary trust assets, \$914 billion, were held in employee benefit accounts; another quarter, \$556 billion, were held in personal trusts; the remaining \$577 billion were held in other accounts, which may include the assets of proprietary mutual funds.² Figure II.1 summarizes the types of trust assets held by banks as of December 1993.

¹Employee benefit accounts include all accounts where the bank acts as trustee or investment manager for employee pension benefit plans. Employee benefit plans are established under ERISA to provide retirement income to employees or result in deferred employee income until the termination of covered employment or beyond. Personal trusts include all private accounts where the bank is appointed to hold title to and manage assets for the benefit of others. Other accounts include estates and other agency accounts. Other agency accounts are similar to personal trusts, but the bank does not hold title to the assets in the account. Proprietary mutual funds managed or advised by a trust department are included in other agency accounts.

²The assets of proprietary mutual funds managed in a trust department are reported as part of a bank's trust report. To the extent that a bank's trust customers are invested in the proprietary mutual funds, the trust assets of the bank are double counted.

Figure II.1: Distribution of Trust Assets as of December 1993



Source: GAO analysis of FDIC data.

Pooled Trust Investment Funds

Pooled trust investment funds are similar in concept to mutual funds, but unlike mutual funds, which may be offered to the general public, pooled trust investment funds are not marketed to the general public. Of the \$2 trillion in discretionary trust assets in 1993, \$760 billion were invested in

pooled trust investment funds composed of pooled employee benefit accounts and pooled personal trust accounts. Separate pools are maintained for these accounts because employee benefit plans have deferred tax status whereas personal trusts generally do not. Pooled personal trust accounts are generally referred to as common trust funds. (See fig. II.1.) Discretionary trust assets are separated into three groups, and for two of these groups—employee benefit plans and personal trusts—the assets are further divided into pooled trust investment funds and individually managed employee benefit plans and personal trust accounts.

Industry officials and regulators we spoke with said that pooled trust investment funds are a likely source of trust assets for conversion into proprietary mutual funds because they are very similar to mutual funds. Accounts that are not invested in pooled trust funds are referred to as individually managed trust accounts. Some of the bankers we interviewed said that individually managed accounts are less likely to be converted into mutual fund investments because of customer preference.

Of the \$914 billion in employee benefit accounts in 1993, \$608 billion, or 67 percent, were invested in pooled funds. By contrast, only \$152 billion of the \$556 billion in personal trust accounts, or 27 percent, were invested in pooled funds (i.e., common trusts). The concentration of pooled employee benefit funds in a few large banks was also greater than that of common trust funds. The five banks with the largest amount of pooled employee benefit funds controlled \$460 billion, or 76 percent, of the total assets in these pools. The five banks with the largest amount of common trust funds held \$46 billion, or only 30 percent of the total assets in these pools. The significance of this concentration is that the scale of future conversions of trust assets into proprietary mutual funds may depend to a great extent on decisions made by a small number of banks.

Pooled Trust Investment Funds and Proprietary Mutual Funds

Pooled trust investment funds provide a large potential source of assets for future conversion to proprietary mutual funds. The number of banks offering one or both types of pooled trust investment funds, however, declined from 895 in 1983 to 533 at the end of 1992. It is possible that bank mergers account for a significant part of this decline. In other cases, banks could have either converted their pooled trust investment funds to proprietary mutual funds or liquidated their pooled funds and invested the proceeds elsewhere.

Table III.1 shows the status of pooled trust investment funds and proprietary mutual funds for 1983, 1988, and 1993. On the basis of data presented in this table, we noted the following changes:

- The assets in employee benefit and common trust funds grew by about 400 percent from 1983 to 1993, to \$760 billion, with employee benefit funds growing faster than common trusts.
- The number of separate pooled trust investment funds declined from more than 4,000 in 1983 to about 3,500 in 1993.
- Assets in the pooled trust investment funds in 1993 were nearly four times as large as assets in proprietary mutual funds, notwithstanding the fact that the banks' proprietary mutual funds grew from relative insignificance to more than \$200 billion in just 10 years. Pooled trust investment funds increased by \$610 billion while proprietary mutual funds increased by \$187 billion. We do not know how much pooled trust investment funds would have grown if proprietary mutual funds had not been available.
- At the end of 1993, about five times as many banks maintained pooled trust investment funds as offered proprietary mutual funds.

**Appendix III
Pooled Trust Investment Funds and
Proprietary Mutual Funds**

Table III.1: Comparison of Pooled Trust Investment Funds and Bank Proprietary Mutual Funds

Dollars in billions			
Type of fund	Number of funds	Number of institutions	Assets
Employee benefit funds			
1983	1,740	603	\$106.0
1988	2,060	491	243.5
1993	1,811	400 ^a	607.6
Common trust funds			
1983	2,296	775	\$43.8
1988	2,063	580	84.8
1993	1,682	473 ^a	152.2
Proprietary mutual funds ^b			
1983	66	^c	\$15.0
1988	304	55	44.6
1993 ^d	1,302	107	202.4

Sources: Trust Assets of Financial Institutions (1983 and 1988) Federal Financial Institutions Examination Council. Preliminary trust data for 1993 from FDIC. Mutual funds data from Lipper Analytical Services.

^aData are for 1992; data for 1993 were unavailable.

^bAssets reported in proprietary mutual funds came from both trust and nontrust sources.

^cData on the number of institutions offering proprietary mutual funds in 1983 were not available.

^dData are as of September 1993.

Table III.1 indicates that pooled trust investment funds have remained an important investment vehicle, despite the smaller number of banks offering them and the start-up of many new proprietary mutual funds. Although customer preference and the relative performance of pooled trust investment funds compared with mutual funds will be important factors in determining whether there are additional conversions of pooled trust investment funds to proprietary mutual funds, several other factors may have an impact on this process. These factors include (1) the profitability of continuing to offer both pooled trust investment funds and proprietary mutual funds, especially since proprietary mutual funds can be offered to a wider range of customers; (2) changes in federal tax laws to allow capital gains accrued in common trusts to be deferred in a conversion; and (3) changes in federal regulation, such as that which has been proposed by OCC for a number of years to allow banks to advertise the performance of their pooled trust investment funds.

Analysis of Trust Assets in Banks That Offered Pooled Trust Investment Funds and Proprietary Mutual Funds

Out of the more than 3,000 banks active in the trust business, about 500 offered pooled trust investment funds at year-end 1992. At the end of 1993, 91 of the banks offering pooled trust investment funds offered proprietary mutual funds as well. As table IV.1 shows, these 91 banks, which we will call dual providers, dominated both markets. They held 95 percent, \$719 billion, of all reported pooled trust investment fund assets and 94 percent, \$191 billion, of all reported proprietary mutual fund assets.¹

Table IV.1: Profile of Banks Offering Both Pooled Trust Investment Funds and Proprietary Mutual Funds

Dollars in billions				
	1988		1993	
	Amount	Percent of total	Amount	Percent of total
Pooled trust investment funds				
Assets	\$294.2	90%	\$719.0	95%
Number of funds	2,582	63	2,394	69
Proprietary mutual funds				
Assets	\$42.4	95%	\$190.6	94%
Number of funds	280	92	1,196	92

Source: FDIC and Lipper Analytical Services.

Table IV.1 also shows that the number of separate pooled trust investment funds offered by dual providers had declined since 1988 while asset growth had been substantial. In about half of these banks, the number of separate pooled trust investment funds decreased, although fewer than one-fourth of the 91 banks reported a decline in the assets of pooled funds over that period. Such declines could reflect different events, such as conversions of trust assets into proprietary or other mutual funds, bank mergers, or trouble at the bank.

The decline in the number of pooled trust investment funds compared to the increase in the number of proprietary mutual funds offered by the dual providers is an interesting development. However, the extent of the shift toward proprietary mutual funds needs to be kept in perspective. Most pooled trust investment funds have not been converted, and in fact their assets are continuing to grow. One indication of the continuing importance of pooled funds is that only 17 of the banks that offered proprietary mutual funds in 1993 had actually discontinued either their common trust funds or

¹Data in this section refer to assets invested in common trusts and pooled employee benefit funds. While most of the 91 banks provided both common trusts and pooled employee benefit funds, a few provided only one type of fund.

Appendix IV
Analysis of Trust Assets in Banks That
Offered Pooled Trust Investment Funds and
Proprietary Mutual Funds

their pooled employee benefit funds since 1986, and only 5 had discontinued both. While a huge potential for future conversions may exist, particularly for employee benefit funds, we have no basis for predicting the extent of future conversions.

In reviewing banks that had pooled trust investment funds, we noted a high and increasing concentration of pooled trust assets. At the end of 1993, the 10 largest banks, measured by their pooled trust investment funds, held 75 percent of all pooled trust investment fund assets. In 1986, the 10 largest banks had only 55 percent of this market. Since 1986, assets in pooled trust investment funds in these banks have grown almost eight times faster than pooled trust assets in smaller banks.² The increase in concentration of these funds among the 10 largest banks indicated that despite the large volume of pooled trust assets managed by banks, many banks are unlikely to reach the scale of assets needed to make a mutual fund viable simply by converting trust assets into a proprietary mutual fund.

The average size of pooled trust investment funds has also grown. This increase in size may make it easier for pooled funds to realize any available economies of scale and may lessen the possibility that pooled trust investment funds would be converted into proprietary mutual funds.

²Each of these 10 banks also offers proprietary mutual funds.

Regulatory Examinations of Trust Departments

The laws and regulations relating to trusts are enforced by OCC, the Federal Reserve, and FDIC. Their oversight authority stems in part from the fact that they are authorized to grant or terminate the trust powers of banks and bank holding companies and their bank and trust subsidiaries. The regulators say that they have the tools necessary to ensure that banks are meeting their trust-related fiduciary responsibilities. Each agency maintains a trust examination manual for the guidance of examiners. We reviewed these manuals and found that they reflected the regulations issued by each agency.

Bank examiners must determine if the bank has resolved any conflicts of interests in favor of the trust account and its beneficiaries. They are also to determine if the bank can justify all trust investments by documented analysis of their historic performance and suitability for the trust involved. Regulatory guidelines and policies require examiners making these determinations to exercise a great deal of judgment in analyzing investment decisions and other aspects of trust activities.

Each of the federal regulatory agencies has a relatively small number of bank examiners specializing in trust activities, although each of these agencies expects all bank examiners to review trust activities, if any, in the banks they examine. The Federal Reserve had 65 trust specialists out of a field force of approximately 1,600 examiners; OCC had 79 out of about 3,220; and FDIC had 21 out of 3,259. OCC stated that it usually examines trust activities as part of its compliance program although the examinations are usually conducted separately from other compliance examinations. FDIC and the Federal Reserve conduct separate trust examinations.

The frequency of trust examinations depends variously on the size of a bank's trust department and its earlier rating, as shown in Table V.1.

Appendix V
Regulatory Examinations of Trust
Departments

Table V.1: Frequency of Examination of Trust Departments, by Federal Bank Regulator

Regulator	Frequency	Criteria
FDIC	Once every 24 months	Banks with better trust ratings
	Once every 12 months	Banks with lower trust ratings
Federal Reserve	Once every 24 months	Large trust departments with good performance ratings
	Once every 36 or 48 months, depending on the size of the trust department	Smaller trust departments with good ratings that have an acceptable state examination in the interim
	Once every 6 to 24 months, depending on the size and condition of the trust department	Trust departments with poorer ratings
OCC ^a	Once every 24 months	Larger trust departments
	Once every 36 months	Smaller trust departments

^aOCC is currently implementing a policy to examine all banks every 24 months. They anticipate that this will be fully implemented in 1996.

Source: GAO construction based on Federal Reserve, OCC, and FDIC information.

OCC, the Federal Reserve, and FDIC use the Uniform Interagency Trust Rating System in their trust examinations. The system was designed to measure performance and identify problems that warrant correction. Banks are rated on six separate components: (1) supervision and organization; (2) operations, controls, and audits; (3) asset administration; (4) account administration; (5) conflicts of interest and self-dealing; and (6) earnings, volume, trends, and future prospects.

Comments From the Office of the Comptroller of the Currency



Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

December 19, 1994

Mr. James L. Bothwell
Director, Financial Institutions and Market Issues
General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Bothwell:

We have received and reviewed your draft audit report titled: **TRUST ASSETS: Investment of Trust Assets in Bank Proprietary Mutual Funds**. The report was prepared in partial response to Congressional requests concerning banks investing assets in trust accounts in bank proprietary mutual funds. We generally concur with the report's conclusions.

The specific comments and observations we had were technical in nature and were provided to your auditors informally.

Thank you for the opportunity to review the draft report.

Sincerely,

Judith A. Walter
Senior Deputy Comptroller for Administration

Comments From the Federal Deposit Insurance Corporation

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Supervision

January 11, 1995

Mr. James L. Bothwell
Director
Financial Institutions and Markets Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

Thank you for providing Chairman Tigert a draft copy of the General Accounting Office's (GAO) report, Investment of Trust Assets in Bank Proprietary Mutual Funds.

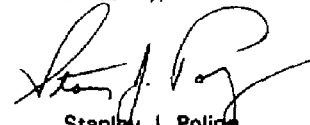
The FDIC staff has reviewed the report and believes it is generally accurate. We note that the report deals more with levels of bank mutual fund activity than supervisory approaches to the activity. Nonetheless, the staff found the GAO report very useful as we draft guidance for our examiners on several aspects of trust investments in bank proprietary mutual funds.

One aspect of the report should perhaps be clarified. On page 21 there is a recitation of advantages cited by bankers of mutual funds over pooled investment trusts (collective investment funds) (CIFs). It is stated that mutual funds are priced daily, offer daily purchases and sales to investors, and offer wider investment choices. The implication is that CIFs do not, and cannot be structured to, offer the same features.

CIFs can offer the same degree of investment diversification as a like-sized mutual fund. With the advent of automated pricing services, CIFs may be priced on a daily basis. Short-term investment funds (STIFs), the CIF equivalent to money market mutual funds, for instance, normally offer both daily pricing and daily entries and withdrawals.

We appreciate this opportunity to provide comments on the GAO report.

Sincerely,



Stanley J. Poling
Director

Comments From the Department of Labor

U.S. Department of Labor

Assistant Secretary for
Pension and Welfare Benefits
Washington, D.C. 20210



Mr. James L. Bothwell
Director, Financial Institutions
and Market Issues
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

We have reviewed the General Accounting Office's draft report entitled "Trust Assets: Investment of Trust Assets in Bank Proprietary Mutual Funds" which you sent to Secretary Reich on November 28, 1994.

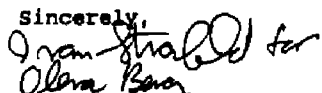
While we have annotated some technical corrections on the enclosed pages of the draft report, we also want to provide an update on the status of the two referrals to the Labor Department mentioned on page 33.

- In October 1993, the Office of the Comptroller of the Currency referred a matter to Labor which involved the conversion of employee benefit funds from a bank's collective trust fund to the same bank's mutual fund. An individual exemption application from ERISA's prohibited transaction restrictions was submitted on behalf of the bank which involves the conversion of a number of bank collective investment funds into mutual funds. The Department is looking into the particular mutual fund that was found by the OCC in its examination of the bank. If the particular conversion raises self-dealing or conflict of interest issues that cannot be satisfactorily resolved, PWBA's Office of Enforcement will get involved in the matter.

- In the second instance mentioned on page 33 ("According to one of the bank regulators, however, another referral to Labor is pending."), we believe that the referral was never actually sent. In trying to identify this referral as part of our review of the draft report, we have been told by our liaison at the Federal Reserve Board that a FRB staff member remarked to GAO that another referral might be made to Labor; however, further examination information established that no violation had occurred and no referral was made.

Appendix VIII
Comments From the Department of Labor

The Department appreciates the opportunity to comment on this draft report. If you have any questions regarding this response, please contact Susan G. Ugelow at 219-8951.

Sincerely,

Olana Berg

Enclosures

Major Contributors to This Report

General Government Division, Washington, D.C.

Thomas J. McCool, Associate Director
Stephen C. Swaim, Assistant Director
Rose M. Kushmeider, Economist-in-Charge
Nancy Eibeck, Evaluator
Charles M. Roberts, Senior Evaluator

Office of the General Counsel, Washington, D.C.

Lorna J. MacLeod, Attorney Advisor

Glossary

Common Trust Fund	A type of pooled trust investment fund maintained by a bank for the collective investment of money held as trustee, executor, administrator, guardian or custodian under a state Uniform Gifts to Minors Act.
Duty of Loyalty	This principle requires a fiduciary to act solely in the interests of his or her clients, excluding all self-interest.
Employee Pension Benefit Plan	ERISA defines employee pension benefit plans as those which provide retirement income to employees or result in deferred employee income for a period extending to the termination of covered employment or beyond.
Employee Retirement Income Security Act of 1974 (ERISA)	A federal statute administered by the Department of Labor, Internal Revenue Service, and Pension Benefit Guaranty Corporation. ERISA regulates the conduct of those charged with administering and investing the assets of privately sponsored employee benefit plans.
Fiduciary	A person acting alone or jointly with others primarily for the benefit of another. The principal function of a fiduciary is the management of property for others.
Investment Advisor	An organization that advises others as to the value of or advisability of investing in securities. A mutual fund employs an investment advisor to give professional advice on its investments and the management of its assets.
Mutual Fund	A company that issues redeemable securities and is engaged primarily in the business of investing or trading in securities. Mutual funds enable investors to pool their money to obtain professional management and diversification of their investments. A mutual fund must stand ready to buy back its shares at their current net asset value. The value of the shares depends on the market value of the fund's portfolio of securities at a given time.

Glossary

Personal Agency Account	In an agency relationship, a customer retains legal ownership of the managed property and receives the beneficial interest in the property. Agency relationships terminate upon the death of the customer.
Personal Trust	In a trust relationship, ownership of and beneficial interest in the trust property are separated. The trustee takes title to the trust property to manage it for the benefit of others.
Pooled Trust Investment Funds	Similar in concept to a mutual fund, except these funds are only available to trust customers as allowed by law or regulation. The term is used in this report to refer to both common trusts and the pooled funds of employee benefit plans.
Proprietary Mutual Fund	Funds advised by the bank, its subsidiary, or an affiliate.
Prudent Man Rule	This principle requires a fiduciary to invest assets in a manner similar to that which would be selected by a prudent person of discretion and intelligence who is seeking a reasonable income and preservation of assets. It is a rule of conduct, not of performance.
Trustee	An individual or institution holding title to and managing trust property on behalf of others.

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

United States
General Accounting Office
Washington, D.C. 20548-0001

Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100

Official Business
Penalty for Private Use \$300

Address Correction Requested

